SUMMARY OF ARGUMENT

SLUSA does not preempt claims brought solely on behalf of plaintiffs who were fraudulently induced to hold or retain a security. Because States have traditionally policed securities fraud, a presumption against preemption applies here, and Petitioner has offered nothing sufficient to overcome it. The text of SLUSA limits its preemptive effect to state class actions alleging fraud "in connection with the purchase or sale of a . . . security." More than twenty years before SLUSA was enacted, this Court interpreted the exact same phrase to limit the scope of an implied private right of action for securities fraud, holding that plaintiffs who did not themselves purchase or sell a security do not have standing to bring a federal securities fraud action. *Blue Chip Stamps*, 421 U.S. at 725-49. Because Congress borrowed language with a settled and widely acknowledged meaning in enacting SLUSA, this Court, as it has done in the past, should presume that Congress was aware of this interpretation and intended to incorporate it as well.

Moreover, allowing States to continue to provide remedies for holder claims strikes an appropriate balance between protecting investors from fraud, while furthering Congress's purpose of discouraging vexatious securities litigation. Investors who hold securities in reliance on a corporation's material representations are surely vulnerable to fraud. Construing SLUSA to preempt such claims would leave these investors with extremely limited recourse. Absent any indication that Congress intended to take away longstanding state-law remedies, their elimination would be wholly unwarranted here.

ARGUMENT

I. SLUSA incorporates the well-settled purchaser/seller limitation on private actions for securities fraud and therefore does not preempt state-law holder claims.

A. Because States have had a longstanding role in protecting against securities fraud, there is a presumption against finding that SLUSA preempts holder claims.

Where a federal statute contains an express preemption provision, as SLUSA does, the task of a reviewing court is to "identify the domain expressly pre-empted by that language." *Medtronic, Inc. v. Lohr*, 518 U.S. 470, 484 (1996) (internal quotation marks and citation omitted). This Court has "never assumed lightly that Congress has derogated state regulation, but instead [has] addressed claims of pre-emption with the starting presumption that Congress does not intend to supplant state law." *New York State Conference of Blue Cross & Blue Shield Plans v. Travelers Ins. Co.*, 514 U.S. 645, 654 (1995). The Court "must fairly but — in light of the strong presumption against pre-emption — narrowly construe the precise language" of a federal provision alleged to preempt a state-law cause of action. *Cipollone v. Liggett Group, Inc.*, 505 U.S. 504, 523 (1992). Thus, the Court "'start[s] with the assumption that the historic police powers of the States were not to be superseded by the Federal Act unless that was the clear and manifest purpose of Congress.'" *Medtronic*, 518 U.S. at 485 (quoting *Rice v. Santa Fe Elevator Corp.*, 331 U.S. 218, 230 (1947)).

The field of securities regulation is one in which States have long exercised their police powers to protect citizen investors, and thus state law should not be deemed preempted without explicit direction from Congress. State common law has long provided remedies for persons injured in securities transactions. Richard W. Painter, *Responding to a False Alarm:*

Federal Preemption of State Securities Fraud Causes of Action, 84 Cornell L. Rev. 1, 20 (1998) (contract remedies for injuries arising out of securities transactions include breach of warranty and rescission and tort remedies include fraud, deceit, and negligent misrepresentation). For more than a century, States have allowed recourse for precisely the type of claim at issue here: fraudulent inducement to hold a security. *See, e.g.*, *Small v. Fritz Cos.*, 30 Cal. 4th 167, 173-83, 65 P.3d 1255, 1258-65 (2003) (cause of action for stockholders induced by fraud or negligent representation to refrain from selling stock); *David v. Belmont*, 291 Mass. 450, 450-54, 197 N.E. 83, 83-85 (1935) (cause of action for fraud where plaintiff alleged defendants fraudulently induced him to hold stock); *Seideman v. Sheboygan Loan & Trust Co.*, 198 Wis. 97, 102-03, 223 N.W. 430, 433 (1929) (cause of action for fraud where bondholder was induced into holding bonds); *Fottler v. Moseley*, 179 Mass. 295, 296-99, 60 N.E. 788, 788-89 (1901) (cause of action for fraud where stockholder was induced to refrain from selling his stock); *Duffy*, 32 A. at 372 (cause of action for fraud where plaintiff retained stock in reliance on defendant's misrepresentations); *Ward v. Atlantic Sec. Bank*, 777 So. 2d 1144, 1146 (Fla. Dist. Ct. App. 2001) (cause of action for fraud where investor alleged defendant fraudulently induced him to hold his shares in a fund); *Continental Ins. Co. v. Mercadante*, 222 A.D. 181, 183-84, 225 N.Y.S. 488, 490-91 (1927) (cause of action for fraud and deceit where plaintiff alleged he was induced to retain securities).

State regulation of securities transactions has an equally long lineage. States began regulating securities in the nineteenth century by imposing registration requirements on certain types of securities offerings, and, in 1911, Kansas enacted the first "Blue Sky Law," which set forth a comprehensive system of registering securities brokers and offerings of securities of all types of enterprises. James D. Cox, et al., *Securities Regulation* 16 (1997). By 1933, nearly every State had enacted such a statute, and today all fifty States and the District of Columbia have Blue

Sky Laws. *Id.* at 16-17; *see also* 1 Louis Loss & Joel Seligman, *Securities Regulation* 41 (3d ed. 1998). Most of these statutes preserve common law remedies and include civil liability provisions that are in addition to and distinct from common law liability. 9 Loss & Seligman, *supra*, at 4114-66.

The crash of the stock market in 1929 led to federal regulation of the securities markets. *See, e.g.*, Cox, *supra*, at 3-16. The purpose of the Securities Act of 1933, Pub. L. No. 73-22, 48 Stat. 74 ("1933 Act"), was to provide investors with full and fair disclosure by regulating disclosures in stock registration statements and prospectuses, and the Securities Exchange Act of 1934, Pub. L. No. 73-291, 48 Stat. 881 ("1934 Act"), provided for the regulation of national securities exchanges to prevent inequitable and unfair practices in the buying and selling of securities. Significantly, while Congress sought to use federal regulation to correct certain inconsistencies in state blue sky laws, it did not preempt state law. Instead, the 1933 and 1934 Acts explicitly preserved state authority and thus established a dual system of securities regulation. *See* 1933 Act, ch. 38, § 16, 48 Stat. at 84 (codified as amended at 15 U.S.C. § 77p) (the rights and remedies prescribed by the 1933 Act are "in addition to any and all other rights and remedies that may exist at law or in equity"); 1934 Act, ch. 404, § 28(a), 48 Stat. at 903 (codified as amended at 15 U.S.C. § 78bb(a)) (expressly preserving state-law remedies).

In 1995, Congress enacted the Private Securities Litigation Reform Act of 1995, Pub. L. No. 104-67, 109 Stat. 737 (the "Reform Act"), in an effort to curb federal "strike suits" — meritless securities class actions brought to force defendants into large settlements. The Reform Act set forth various procedural requirements for federal securities class actions, making it more difficult for plaintiffs' lawyers to file frivolous class actions. *See* 15 U.S.C. §§ 77z-1(b), 78u-4(b). Even as it reformed federal securities litigation, however, Congress continued to preserve state-law remedies and maintain a balance

between federal and state power in this area. *See Securities Litigation Uniform Standards Act of 1997 – S. 1260: Hearing Before the Subcomm. on Securities of the S. Comm. on Banking, Housing, and Urban Affairs*, 105th Cong. 34 & n.33 (1998) (hereinafter "*1998 Hearing on S. 1260*") (prepared statement of Richard W. Painter, Professor, Cornell Law School) (citing *Hearings Concerning Common Sense Legal Reform Act Before the Subcomm. on Telecomm. and Finance of the H. Comm. on Commerce*, 104th Cong. 110 (1995)).

In 1998, Congress concluded that some plaintiffs' lawyers were circumventing Reform Act requirements by filing securities class actions in state court instead of federal court. SLUSA was enacted to close this perceived loophole. The statute amended the 1933 and 1934 Acts to expressly preempt certain state-law class actions. *See* H.R. Conf. Rep. No. 105-803, at 13 (1998). In doing so, SLUSA became the first federal legislation to displace state-law private causes of action as a remedy for securities fraud.

In addition to displacing longstanding state authority, SLUSA's preemption dramatically limits the recourse available to injured and deserving plaintiffs. If the statute is construed to preempt state-law holder class actions, then persons fraudulently induced to hold a security will be left without a class-action remedy. *See infra* at 16. The Court should be particularly reluctant to expand the scope of a statute's preemption beyond Congress's express intent where, as here, doing so would wholly deprive deserving litigants of a cause of action. *See, e.g.*, *Medtronic*, 518 U.S. at 487 (plurality opinion) (because there is no federal private cause of action against manufacturers, preemption of state-law negligence claims would "have the perverse effect of granting complete immunity from design defect liability"); *Silkwood v. Kerr-McGee Corp.*, 464 U.S. 238, 251 (1984) (finding it "difficult to believe that Congress would, without comment, remove all means of judicial recourse for those injured by illegal conduct"); *Franchise Tax Bd. v. Construction Laborers Vacation Trust*, 463 U.S. 1, 26 (1983)

(Congress's failure to provide a federal right of action to vindicate a preempted claim provided further evidence that Congress did not mean for ERISA to preempt claims that were not explicitly identified in the statute).

Because SLUSA alters the longstanding shared authority of federal and state governments to address securities fraud and limits the recourse available to injured investors, the scope of SLUSA's preemption must be informed by a strong presumption against preemption.

B. In enacting SLUSA's preemption provision, Congress used a phrase with a settled meaning that is limited in scope to actions brought by purchasers or sellers of a covered security.

SLUSA provides that "[n]o . . . class action" based upon state statutory or common law may be brought in state or federal court by a private party alleging "a misrepresentation or omission of a material fact in connection with the purchase or sale of a covered security," 15 U.S.C. § 78bb(f)(1)(A), or the use of "any manipulative or deceptive device or contrivance in connection with the purchase or sale of a covered security," *id.* § 78bb(f)(1)(B); *see also id.* § 77p(b) (amending the 1933 Act in the same manner).[1] SLUSA thus can preempt state-law actions alleging fraud only "in connection with the purchase or sale of a . . . security."

SLUSA does not define or otherwise explain the phrase "in connection with the purchase or sale of a . . . security." However, at the time SLUSA was enacted, this Court had construed the same language in § 10(b) of the 1934 Act and Securities and Exchange Commission ("SEC") Rule 10b-5.

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1. SLUSA also includes a removal provision, which states that "[a]ny covered class action brought in any State court involving a covered security . . . shall be removable to the Federal district court for the district in which the action is pending" and shall be subject to preemption. 15 U.S.C. § 78bb(f)(2).

See Blue Chip Stamps, 421 U.S. at 725. Section 10(b) makes it unlawful "[t]o use or employ, *in connection with the purchase or sale of [a] security* . . . any manipulative or deceptive device or contrivance in contravention of such rules and regulations as the [SEC] may prescribe." 15 U.S.C. § 78j(b) (emphasis added). Rule 10b-5 likewise forbids the use, "*in connection with the purchase or sale of [a] security*," of "any device, scheme, or artifice to defraud" or any other "act, practice, or course of business" that "operates . . . as a fraud or deceit." 17 C.F.R. § 240.10b-5 (emphasis added). Section 10(b) and Rule 10b-5 establish criminal and regulatory liability for fraud in connection with the purchase or sale of a security, but do not provide an express private right of action. *Blue Chip Stamps*, 421 U.S. at 729-30. However, courts have found an implied private right of action under § 10(b) and Rule 10b-5, and, over time, have defined the elements and scope of the right. *Id.* at 730; *see also Central Bank v. First Interstate Bank*, 511 U.S. 164, 191 (1994) (private plaintiff may not maintain aiding and abetting suit under § 10(b)), *abrogated on other grounds by* Reform Act, § 104, 109 Stat. at 757 (codified at 15 U.S.C. § 78t); *Ernst & Ernst v. Hochfelder*, 425 U.S. 185, 193 (1976) (to maintain Rule 10b-5 action, plaintiff must allege that defendant acted with an "intent to deceive, manipulate, or defraud"); *Lampf, Pleva, Lipkind, Prupis & Petigrow v. Gilbertson*, 501 U.S. 350, 364 (1991) (§ 10(b) and Rule 10b-5 litigation must be commenced within one year after the discovery of the violation and within three years after such violation occurs).

In *Blue Chip Stamps*, this Court considered the meaning of the phrase "in connection with the purchase or sale of a . . . security" in the context of a Rule 10b-5 private cause of action. The case involved a putative class of offerees who had alleged that the defendants issued an intentionally misleading prospectus in order to discourage purchases by the alleged class, so that the rejected shares could then be sold at a premium to the public. *Blue Chip Stamps*, 421 U.S. at 726-27. In the absence of any evidence that Congress, in enacting § 10(b), intended to extend

a private cause of action to individuals who had neither purchased nor sold stocks, the court declined to confer standing on such individuals to pursue a Rule 10b-5 action. *Id.* at 725-49.

Petitioner argues that because *Blue Chip Stamps* established a standing rule for private causes of action, the Court was not interpreting the phrase "in connection with the purchase or sale of a . . . security" and the *Blue Chip Stamps* limitation thus cannot be read into SLUSA's preemption provision. Petitioner's Br. at 29-30. However, while *Blue Chip Stamps* held that the plaintiff class lacked standing, it is incontrovertible that the Court's analysis and decision rested on its interpretation of the phrase "in connection with the purchase or sale of a . . . security." By the time Congress enacted SLUSA, that phrase thus had a longstanding, firmly established meaning, which excluded claims brought by nonpurchasers or nonsellers.[2] "When . . .

2. Relying on concurring opinions in *Holmes v. Securities Investor Protection Corp.*, 503 U.S. 258 (1992), Petitioner states that the Court "clearly" has stated that the purchaser/seller limitation is not a construction of the phrase "in connection with the purchase or sale of a . . . security." Petitioner's Br. at 3, 32. Both concurring opinions in *Holmes* concluded that the purchaser/seller limitation would not apply to suits brought under the Racketeer Influenced and Corrupt Organizations Act ("RICO"). Justice O'Connor noted that the purchaser/seller limitation "rests on the relationship between § 10(b) and other provisions of the securities laws . . . and the practical difficulties in granting standing in the absence of an executed transaction, . . . neither of which are relevant in the RICO context." *Holmes*, 503 U.S. at 284 (O'Connor, J., concurring in part and concurring in the judgment). Justice Scalia concluded that because *Blue Chip Stamps* involved "specification of the contours of a Rule 10b-5 action 'implied' (*i.e.*, created) by the Court itself," the limitation could not be read into RICO, which "contains no hint of such limitation." *Id.* at 289 (Scalia, J., concurring in the judgment). Unlike RICO, SLUSA deals explicitly and exclusively with the types of actions addressed in *Blue Chip Stamps*. Therefore, regardless of whether they are relevant in the RICO context, the *Blue Chip Stamps* limitation is relevant here, where Congress chose to use the same language to limit the scope of preemption for the same types of actions.

judicial interpretations have settled the meaning of an existing statutory provision, repetition of the same language in a new statute indicates, as a general matter, the intent to incorporate its . . . judicial interpretations as well." *Bragdon v. Abbott*, 524 U.S. 624, 645 (1998); *see also National Labor Relations Bd. v. Amax Coal Co.*, 453 U.S. 322, 329 (1981) ("Where Congress uses terms that have accumulated settled meaning under either equity or the common law, a court must infer, unless the statute otherwise dictates, that Congress means to incorporate the established meaning of these terms.").

Moreover, while it was never a focus of debate, the *Blue Chip Stamps* limitation is mentioned in various parts of SLUSA's legislative history, further supporting the inference that Congress was aware of the purchaser/seller limitation on federal securities law claims when it enacted SLUSA. *See, e.g.*, 144 Cong. Rec. H10,775 (1998) (Joint Explanatory Statement of the Comm. of Conf.) ("there is no remedy under Section 10(b) for those who neither purchase nor sell securities") (citing *Blue Chip Stamps*, 421 U.S. at 734); *1998 Hearing on S. 1260, supra*, at 34 (statement of Richard W. Painter) ("a Federal plaintiff may not sue a person whose fraudulent statements induced her not to sell an overvalued security in her portfolio") (citing *Blue Chip Stamps*, 421 U.S. 723); *Securities Litigation Uniform Standards Act: Hearing Before the Subcomm. on Finance and Hazardous Materials of the H. Comm. on Commerce*, 105th Cong. 77 (1998) (statement of Richard W. Painter) (same). By choosing to use language that it knew had been defined by this Court to exclude nonpurchasers and nonsellers in the context of a private right of action, Congress effectively incorporated the purchaser/seller limitation on the scope of SLUSA preemption.

Petitioner does not dispute that this Court's construction of the phrase "in connection with the purchase or sale of a . . . security," as used in § 10(b) and Rule 10b-5, is relevant in interpreting the same phrase as used in SLUSA, but argues that the phrase should not be interpreted to incorporate the *Blue Chip*

Stamps purchaser/seller limitation because this Court has interpreted this phrase more broadly in *United States v. O'Hagan*, 521 U.S. 642 (1997), and *SEC v. Zandford*, 535 U.S. 813 (2002). Petitioner's Br. at 24-29; *see also Kircher v. Putnam Funds Trust*, 403 F.3d 478, 483 (7th Cir. 2005) (*Blue Chip Stamps* "deals with private actions alone and does not restrict coverage of the statute and regulation"). Neither *O'Hagan* nor *Zandford* overrule or amend the *Blue Chip Stamps* holding or analysis in any way, nor do they set forth a different understanding of the scope of the phrase "in connection with the purchase or sale of a . . . security" as applied in the context of a private action. Even if these cases construed § 10(b) and Rule 10b-5's prohibition on fraud as allowing actions that are not limited to deception directed at or affecting identifiable purchasers or sellers, that prohibition is fully enforceable only by the government; private actions for damages are restricted to purchasers and sellers alone. Because SLUSA deals with precisely the category of actions subject to the purchaser/seller rule — *i.e.*, private causes of action for damages — and was enacted after *Blue Chip Stamps* was decided and applied by lower courts, it is "far more natural to suppose that Congress meant to import the settled standing rule" than to suppose that it meant to apply the fraud analysis from government cases. *Dabit v. Merrill Lynch, Pierce, Fenner & Smith, Inc.*, 395 F.3d 25, 40 (2d Cir. 2005).[3]

Debate on both the Reform Act and SLUSA confirm that Congress understood that by remaining silent on the manner in which this Court had defined the scope of a private right of

3. *O'Hagan* is particularly inapposite. As the Court noted there, the manner in which the phrase "in connection with the purchase or sale of a . . . security" is construed in the context of private actions is irrelevant in the criminal context. *O'Hagan*, 521 U.S. at 664-65; *see also Holmes*, 503 U.S. at 280 (O'Connor, J., concurring in part and concurring in judgment) ("[T]he purchaser/seller standing requirement for private civil actions under § 10(b) and rule 10b-5 is of no import in criminal prosecutions for willful violations of those provisions.").

action under Rule 10b-5, the Reform Act and SLUSA implicitly incorporated any limitations imposed by the Court. For example, in *Lampf v. Gilbertson*, the Court held that the applicable statute of limitations for private rights of action under § 10(b) is one year after the plaintiff knew of the violation and in no event more than three years after the violation occurred. *Lampf*, 501 U.S. at 364. While the question of an appropriate statute of limitations was debated in hearings on both the Reform Act and SLUSA, the SLUSA Senate Committee Report notes that by not specifying a different statute of limitations, the legislation "left intact the shorter statute of limitations adopted by *Lampf*." S. Rep. No. 105-182, at 16-17, 20-21 (1998).

Similarly, in *Central Bank v. First Interstate Bank*, the Court held that § 10(b) "prohibits only the making of a material misstatement (or omission) or the commission of a manipulative act[,]" and does not reach those who aid or abet a person who commits a manipulative or deceptive act. *Central Bank*, 511 U.S. at 177-78. Again, whether the Reform Act or SLUSA should expand private rights of action to include actions for aiding and abetting was hotly contested during hearings on both pieces of legislation, but in the end, both statutes remained silent, followed *Central Bank*, and thus failed to restore aiding and abetting liability under § 10(b) and Rule 10b-5. *See* S. Rep. No. 105-182, *supra*, at 17-18 (noting that the Reform Act ignored recommendations to restore aiding and abetting liability for private investors and left the *Central Bank* holding in place).

SLUSA's proponents made it clear that the statute was a targeted approach to the specific problem of class actions migrating to state court after the Reform Act. *See, e.g.*, 143 Cong. Rec. S10,477 (1997) (statement of Sen. Dodd, co-sponsor) (SLUSA will "allow Congress to address this State litigation problem . . . in a very targeted and narrow way, essentially preempting only those class actions that have recently migrated to State court, while leaving traditional State court actions and procedures solidly in place"); *Securities Litigation*

Uniform Standards Act of 1997 – S. 1260: Hearing Before the Subcomm. on Securities of the S. Comm. on Banking, Housing, and Urban Affairs, 105th Cong. 7-8 (1997) (statement of Rep. Eshoo, co-sponsor of House bill) ("I would like to make clear that the bill is not a Federal power grab. This is returning to Federal courts the cases which, until the 1995 Reform Act, had always been heard in Federal courts. It is limited in scope . . . It's a targeted approach to a specific problem."); *Implementation of the Private Securities Litigation Reform Act of 1995: Hearing Before the Subcomm. on Finance and Hazardous Materials of the H. Comm. on Commerce*, 105th Cong. 39 (1997) (statement of Rep. Eshoo, co-sponsor) (stating that "[w]e're looking at some very, very narrow areas" and noting that the concern is "the migration of 10(b)(5) cases"). After *Blue Chip Stamps*, holder actions could be brought only in state court. Therefore, these actions were not subject to the Reform Act's procedural requirements, nor could they have migrated to state court after the Reform Act was enacted. Congress was aware of the *Blue Chip Stamps* limitation, chose to use the same language the Court found excluded holder claims, and did nothing to suggest it intended to reach these claims that were otherwise outside of SLUSA's targeted scope.

Petitioner asks the Court to assume that holder claims were a target of SLUSA because they are "among the most vexatious types of claims" and "least likely to present meritorious grounds for recovery of damages." Petitioner's Br. at 41. A number of States have themselves taken steps to limit holder claims. *See infra* at 18. And in any event, while policy concerns about the danger of vexatious litigation may provide support for denying a federal private right of action when state causes of action are available, *see Blue Chip Stamps*, 421 U.S. at 740, it is a wholly insufficient basis on which to find preemption.

If, as Petitioner suggests, frivolous holder actions are in fact impeding the purposes of the Reform Act or SLUSA, Congress can, as it has done in the past, address the problem through the legislative process. As the Court noted in *Blue Chip Stamps*, "[w]e are dealing with a private cause of action which has been judicially found to exist, and which will have to be judicially delimited one way or another unless and until Congress addresses the question." *Id.* at 749. Although Congress has reviewed the federal securities laws and explicitly considered the contours of the private cause of action, it has remained silent about whether the cause of action extends to nonpurchasers and nonsellers. Therefore, judicial interpretations of the private right of action control, and the Second Circuit correctly held that SLUSA does not preempt class actions brought solely on behalf of persons fraudulently induced to hold or retain a security.[4]

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4. A majority of the courts that have considered the issue agree. *See, e.g., Riley v. Merrill Lynch, Pierce, Fenner & Smith, Inc.*, 292 F.3d 1334, 1345 (11th Cir. 2002) ("SLUSA does *not* apply to claims dealing *solely* with the retention of securities, rather than with purchase or sale" but finding allegations in this case not limited to retention of securities) (emphasis in original); *Green v. Ameritrade, Inc.*, 279 F.3d 590, 598 (8th Cir. 2002) (SLUSA does not make class actions on behalf of "nonsellers" and "nonpurchasers" removable to federal court); *Gutierrez v. Deloitte & Touche, L.L.P.*, 147 F. Supp. 2d 584, 594-95 (W.D. Tex. 2001) (SLUSA does not apply where plaintiff seeks damages for being fraudulently induced to hold a stock); *Shaw v. Charles Schwab & Co.*, 128 F. Supp. 2d 1270, 1272-74 (C.D. Cal. 2001) (SLUSA does not bar a state fraud claim where the alleged fraud caused plaintiffs to choose a brokerage firm not to buy or sell a security); *Abada v. Charles Schwab & Co.*, 127 F. Supp. 2d 1101, 1103 (S.D. Cal. 2000) (SLUSA does not preempt claim where defendant's alleged conduct did not involve the trading of a security); *Gordon v. Buntrock*, No. 00 CV 303 (JFH), 2000 U.S. Dist. LEXIS 5977, 2000 WL 556763, at *4 (N.D. Ill. Apr. 28, 2000) (Memorandum Opinion and Order) (plaintiff's claim was not removable under SLUSA because complaint did not allege that defendant's misrepresentations were made in connection with the

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II. Construing SLUSA to allow state-law remedies for holder claims strikes an appropriate balance between protecting investors from fraud and furthering Congress's purpose of promoting consistent and efficient markets.

Federal securities law strikes a balance between uniform regulation of national markets and preservation of areas "traditionally relegated to state law." *Santa Fe Indus. v. Green*, 430 U.S. 462, 478-80 (1977) (internal quotation marks and citation omitted) (discussing principles of federalism and holding that claims challenging "internal corporate mismanagement" are not actionable under § 10(b))). That balance is appropriately struck here by construing SLUSA as continuing to allow injured investors to seek recourse for holder claims under state law, while preempting class actions that had migrated to state court after passage of the Reform Act.

First, investors induced to hold a security are at least as vulnerable to fraud as those induced to purchase or sell a security. Many victims of recent corporate frauds are those who were induced to hold their shares while insiders who knew the true state of the company sold at inflated prices. *See, e.g.*, *In re WorldCom, Inc. Sec. Litig.*, 336 F. Supp. 2d 310, 318-23 (S.D.N.Y. 2004) (analyzing holder claims brought against WorldCom defendants); *In re WorldCom, Inc. Sec. Litig.*, 382 F. Supp. 2d 549, 558-60 (S.D.N.Y. 2005) (same); *Small*, 30 Cal. 4th 167, 181, 65 P.3d at 1263-64 (citing examples).

Second, and perhaps more important, if SLUSA is construed to preempt actions brought by investors who neither purchased

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purchase or sale of a covered security); *Hines v. ESC Strategic Funds, Inc.*, No. 3:99-0530 (AAT), 1999 U.S. Dist. LEXIS 15790, 1999 WL 1705503, at *5-6 (M.D. Tenn. Sept. 17, 1999) (holding that SLUSA does not apply to state-law claims for breach of fiduciary duty that occurred after the sale of the securities in question).

nor sold securities during the relevant period, SLUSA would preempt any state class action these investors might have, and because they were not induced to purchase or sell a security, they would also lack standing to bring a federal action under *Blue Chip Stamps*. While plaintiffs would remain free to bring state-law actions for securities fraud, because of the nature of holder claims and the relatively small amount of damages typically suffered by one person, individual plaintiffs will generally lack the resources and incentive to bring individual actions. *See Amchem Prods. v. Windsor*, 521 U.S. 591, 617 (1997) ("'The policy at the very core of the class action mechanism is to overcome the problem that small recoveries do not provide the incentive for any individual to bring a solo action prosecuting his or her rights.'") (quoting *Mace v. Van Ru Credit Corp.*, 109 F.3d 338, 344 (1997)). Similarly, state government action is not sufficient by itself. *See, e.g.*, H.R. Conf. Rep. No. 104-369, at 31 (1997) ("Private securities litigation is an indispensable tool with which defrauded investors can recover their losses without having to rely upon government action."); *Securities Litigation Abuses: Hearing Before the Subcomm. on Securities of the S. Comm. on Banking, Housing, and Urban Affairs*, 105th Cong. 10 (1997) (Opening Statement of Arthur Levitt, Chairman, U.S. Securities and Exchange Commission) ("The Commission continues to believe that private actions provide valuable and necessary additional deterrence against the temptation to commit securities fraud, thereby supplementing the Commission's own limited enforcement activities.").

There is no indication that Congress intended such a draconian result. In *Blue Chip Stamps*, the Court concluded that any harsh effects caused by restricting private actions to purchasers and sellers would be mitigated "to the extent that remedies are available to nonpurchasers and nonsellers under state law." *Blue Chip Stamps*, 421 U.S. at 738, n.9. In the Court's view, the considerations that justified denying investors a federal

forum for their holder claims did not warrant denying them relief altogether. To the contrary, it would be "undesirable" to eliminate a federal cause of action if no other avenue for redress existed. *Id.* at 738-39. As the Second Circuit concluded, "SLUSA's wholesale importation of the language that gave rise to this balancing judgment must therefore be presumed to represent a ratification of that judgment." *Dabit*, 395 F.3d at 40 (citing *Merrill Lynch, Pierce, Fenner & Smith, Inc. v. Curran*, 456 U.S. 353, 381-82 (1982); *Calif. Public Employees' Ret. Sys. v. WorldCom, Inc.*, 368 F.3d 86, 105 & n.17 (2d Cir. 2004)).[5]

Nor does anything in SLUSA's legislative history suggest that Congress rejected this longstanding federal-state balance of power. Indeed, SLUSA's proponents indicated that it would not take away rights of investors who had been harmed. *See, e.g.*, 144 Cong. Rec. H6,058 (1998) (statement of Rep. Tauzin) ("Have we taken away any legitimate rights of people who have been harmed? No."). For example, in supporting the Conference Report on the bill that would become SLUSA, one of the bill's co-sponsors assured potential opponents of the bill that "[i]f there is intentional fraud, there is nothing in this legislation or in the Reform Act to prevent those cases from proceeding." 144 Cong. Rec. H11,020 (1998) (statement of Rep. Bliley). Even if Congress recognized that the pleading requirements imposed by SLUSA and the Reform Act would make some forms of relief more difficult for plaintiffs to obtain, it demonstrated no intent to completely deprive a group of injured investors of a cause of action.

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5. Nor does any possible concern with uniformity justify striking a different balance. As this Court has held, such an interest "is not unyielding" and "does not justify the displacement of state common-law remedies that compensate accident victims and their families." *Sprietsma v. Mercury Marine*, 537 U.S. 51, 70 (2002); *see also Medtronic*, 518 U.S. at 495 (traditional state-law damages remedies provide additional incentives for manufacturers to comply with federal manufacturing and labeling requirements).

State-law remedies for holder claims further Congress's objectives by compensating victims and creating additional incentives for corporations to comply with securities laws. At the same time, there is no evidence that allowing States to make remedies available for holder claims has led or will lead to a flood of frivolous strike suits. Indeed, States are limiting this risk themselves by imposing heightened pleading requirements or other limitations on holder claims. *See, e.g.*, *Small*, 30 Cal. 4th 167, 183-85, 65 P.3d at 1265-66 (California recognizes causes of action for fraud and negligent misrepresentation where plaintiff retains stock in reliance on defendant's false representation, but requires such claims to be pled with specificity); *see also Rogers v. Cisco Systems*, 268 F. Supp. 2d 1305, 1311-12 (N.D. Fla. 2003) (applying Florida law and imposing heightened pleading standards on holder claims); *Gutman v. Howard Savings Bank*, 748 F. Supp. 254, 263 (D.N.J. 1990) (under New York and New Jersey law, a "plaintiff may state a common law fraud claim against a defendant whose misrepresentations caused plaintiff to hold securities which plaintiff otherwise would have sold" where defendant's alleged misrepresentations were made in direct dealings with plaintiff). It is thus unnecessary to expand SLUSA's preemption — and further displace States' authority — in order to further Congress's objectives.

CONCLUSION

For the foregoing reasons, this Court should affirm the decision of the United States Court of Appeals for the Second Circuit.

Respectfully submitted,

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No. 04-1371

In the Supreme Court of the United States

MERRILL LYNCH, PIERCE, FENNER & SMITH, INC,
Petitioner.

V.

SHADI DABIT ON BEHALF OF HIMSELF AND ALL OTHERS SIMILARLY SITUATED,
Respondent.

ON WRIT OF CERTIORARI TO THE UNITED STATES COURT OF APPEALS FOR THE SECOND CIRCUIT

BRIEF OF PACIFIC LIFE INSURANCE COMPANY AS *AMICUS CURIAE* IN SUPPORT OF PETITIONER

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INTEREST OF THE *AMICUS CURIAE*[1]

A key legal question to be decided in this case significantly affects *amicus'* interests. Pacific Life Insurance Company ("Pacific Life") offers variable annuity contracts that permit contract holders to allocate their premium payment(s) to investments, including mutual funds. These are securities to which the Securities Litigation Uniform Standards Act of 1998 ("SLUSA") applies. Pacific Life was named as defendant in class action litigation filed in Madison County, Illinois. The case—*Spurgeon v. Pacific Life Insurance Company*—was one of the cases consolidated and decided in *Kircher v. Putnam Funds Trust*, 403 F.3d 478 (7th Cir. 2005).

It was with respect to Pacific Life that the Seventh Circuit reached the question of whether the preemptive scope of SLUSA is limited by the purchaser-seller requirement recognized in *Blue Chip Stamps v. Manor Drug Stores*, 421 U.S. 723 (1975). The Seventh Circuit's decision that the purchaser-seller requirement does not limit the scope of SLUSA preemption was the basis of its ruling that the state law claims against Pacific Life are preempted. *Kircher*, 403 F.3d at 483-84. A petition for certiorari in *Kircher* is currently before this Court. In addition, Mr. Spurgeon's appeal from the decision of the United States District Court for the Southern District of Illinois on remand is pending in the Seventh Circuit.

The question presented in the instant case involves the same determination—whether the purchaser-seller limitation was incorporated into SLUSA. *Amicus*, therefore, has a significant and immediate interest in the question presented in this case and its views can assist the Court in resolving this question.

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[1] The parties have consented to the submission of this brief. Their letters of consent have been filed with the Clerk of this Court. Pursuant to Supreme Court Rule 37.6, no counsel for a party authored the brief in whole or in part and no person or entity other than Pacific Life or its counsel made a monetary contribution to the preparation or submission of this brief.

SUMMARY OF ARGUMENT

Analytically, this case presents two questions. The question presented requires a determination of whether the purchaser-seller requirement recognized by this Court in *Blue Chip Stamps v. Manor Drug Stores*, 421 U.S. 723 (1975), was incorporated into SLUSA by Congress, and thereby imposes a limit on SLUSA's preemptive reach.[2] The application to a particular case requires a determination whether SLUSA preemption reaches the misconduct alleged in the case—*i.e.*, whether it is sufficiently related to securities transactions to satisfy the statute's "in connection with" requirement.

Blue Chip Stamps and this Court's subsequent decisions establish that the purchaser-seller requirement was not found in Section 10(b)'s statutory text and, therefore, was not incorporated into SLUSA when Congress borrowed Section 10(b) language in drafting SLUSA. Pts. I, II. The second question requires a case-by-case determination. If the Court reaches that determination in the instant case, *amicus* urges the Court to consider additional contexts in which the relationship between alleged misconduct and securities transactions is presented—including claims arising from market-timed securities transactions—and to frame any determination in the instant case with those situations in mind. Pt. III.

ARGUMENT

I. THE LANGUAGE CONGRESS BORROWED FOR SLUSA DID NOT INCLUDE THE *BLUE CHIP STAMPS* PURCHASER-SELLER LIMITATION.

Blue Chip Stamps and its progeny offer no support for the Second Circuit's conclusion that Congress limited the

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[2] SLUSA, P.L. 105-353, 112 Stat. 3227, is *codified at* both 15 U.S.C. §§ 77p and 78bb(f) (amending, respectively, the Securities Act of 1933 and the Securities Exchange Act of 1934).

scope of SLUSA preemption to actions brought by purchasers or sellers when it borrowed the "in connection with" language from Section 10(b) of the Securities Exchange Act of 1934, or the identical language in Rule 10b-5, to define SLUSA preemption. *See* 15 U.S.C. § 78j(b); 17 C.F.R. § 240.10b-5. This Court did not find the purchaser-seller requirement it recognized in *Blue Chip Stamps* in the "in connection with" language of Section 10(b) or Rule 10b-5. The Court fashioned the requirement as a permissible policy-driven limit on the private right of action that courts had already fashioned. *Blue Chip Stamps* made clear that the limitation was not found in the statutory text of 10(b) or the regulatory text of Rule 10b-5, and opinions from this Court and individual justices have repeatedly confirmed this understanding.

A. *Blue Chip Stamps* Repeatedly Explains That the Purchaser-Seller Limitation Is Not An Interpretation of Section 10(b)'s "In Connection With" Provision. B.

Blue Chip Stamps, in discussing its decision to adopt the purchaser-seller requirement, emphasized that it had not found the requirement in Section 10(b) itself or in SEC Rule 10b-5, much less their "in connection with the purchase or sale of any security" language. Rather, the Court concluded that neither Congress nor the SEC had expressly provided or contemplated a private right of action under Section 10(b) or Rule 10b-5, and that "[n]o language in either of those provisions *speaks at all* to the contours of a private cause of action for their violation." *Blue Chip Stamps*, 421 U.S. at 749 (emphasis added). Rather, the Court explained, "We are dealing with a private cause of action which has been judicially found to exist, and which will have to be judicially delimited one way or another unless and until Congress addresses the question." *Id.*

The Court reiterated, in announcing the purchaser-seller requirement as a limitation on this private right of

action, that it was not interpreting statutory text. "[W]e would by no means be understood as suggesting that we are able to divine from the language of § 10(b) the express 'intent of Congress' as to the contours of a private cause of action under Rule 10b-5." 421 U.S. at 737. Rather, the Court explained, "When we deal with private actions under Rule 10b-5, we deal with a judicial oak which has grown from little more than a legislative acorn." *Id.*

The Court considered the statutory provision, its legislative history and related provisions to determine that "in fashioning substantive law," *id.* at 742, it was not promulgating a judge-made restriction that was inconsistent with the statute. Its review reassured the Court that the requirement was consistent with *other* provisions in which Congress expressly provided for a private right of action, *id.* at 736, and what it could "glean from the intent of Congress," *id.* at 749, and that Congress itself recognized the potential for nuisance suits in 1934, *id.* at 740-41. Therefore, it concluded that imposing the limitation was permissible. *Id.* at 749.

1. The requirement was founded upon policy considerations.

The Court justified the purchaser-seller limitation by considering its own view of the wisdom of such a limitation. The Court recognized that "if Congress had legislated the elements of a private cause of action for damages, the duty of the Judicial Branch would be to administer the law which Congress enacted." *Id.* at 748. However, the Court explained, Congress had not done so. Thus, it concluded that "we are free to weigh" what it termed "considerations of policy." *Id.* at 749.

The considerations that weighed most heavily—"purely as a matter of policy"—were: (a) the "widespread recognition that litigation under Rule 10b-5 presents a danger of vexatiousness different in degree and in kind from that which accompanies litigation in general," *id.* at 739, (b) the

recognition that "[t]he very pendency of the lawsuit may frustrate or delay normal business activity of the defendant" leading to settlements "out of any proportion to its prospect of success at trial," *id.* at 740, and (c) "[t]he potential for possible abuse of the liberal discovery provisions" permitting "a plaintiff with a largely groundless claim to simply take up the time of a number of other people, with the right to do so representing an *in terrorem* increment of the settlement value," *id.* at 741.

By adopting the purchaser-seller requirement, the Court strove to curb nuisance suits based on "hazy issues of historical fact," *id.* at 743, and "the possibility that unduly expansive imposition of civil liability will lead to large judgments, payable in the last analysis by innocent investors, for the benefit of speculators and their lawyers," *id.* at 739 (citation and quotation omitted). Having given these "practical factors . . . a good deal of weight," the Court determined "it is a sound rule and should be followed." *Id.* at 749.

2. The Court recognized the limitation was narrower than the statute.

Moreover, *Blue Chip Stamps* expressly recognized that its purchaser-seller requirement was not co-extensive with the statute, but narrower, and that the requirement would therefore preclude suits that, in fact, *met* the statutory requirement that a suit be "in connection with the purchase or sale of a security." 15 U.S.C. § 78j(b). In considering the policy implications of adopting the limitation, the Court noted that one of the categories of suits that would be precluded by a purchaser-seller requirement would be suits by shareholders whose shares lost value "due to corporate or insider activities in connection with the purchase or sale of securities *which violate Rule 10b-5.*" 421 U.S. at 738 (emphasis added). Later in the opinion, the Court recognized again that the limitation "undoubtedly excludes plaintiffs who have in fact been damaged by violations of

Rule 10b-5." *Id.* at 743. If the Second Circuit were correct that the purchaser-seller requirement is an interpretation of Section 10(b)'s text, *i.e.*, a requirement imposed by the statute, the requirement would preclude exactly the same actions that the statute itself precludes—not *additional* ones.

In addition, if the requirement were an interpretation of statutory text, it would necessarily apply equally to suits brought by the SEC and suits brought by private plaintiffs. Section 10(b) provides the definition of the conduct that constitutes a violation. Nothing in the text distinguishes between misconduct the SEC may use its enforcement powers to punish and misconduct for which a private party may recover. Congress provided only one definition. *Blue Chip Stamps* expressly recognized again that this one definition—Section 10(b) itself—did not supply the purchaser-seller limitation when it clarified that the judicially-crafted requirement "imposes no limitation on the standing of the SEC to bring actions" under Section 10(b) or Rule 10b-5. *Id.* at 752 n.14.

B. This Court Has Repeatedly Confirmed That the Purchaser-Seller Limitation Is Not Found in the Statutory Text.

Since *Blue Chip Stamps*, opinions by the Court and individual justices have repeatedly confirmed that the purchaser-seller requirement is a judicially-fashioned restriction and not a requirement imposed by the statute. As Justice O'Connor succinctly noted in *Holmes v. Securities Investor Protection Corp.*, "The purchaser/seller standing limitation in Rule 10b-5 damages actions . . . does not stem from a construction of the phrase 'in connection with the purchase or sale of any security.' " 503 U.S. 258, 284 (1992) (O'Connor, J., concurring in part and concurring in the judgment). Similarly, *United States v. O'Hagan*, 521 U.S. 642, 664 (1997), confirmed that *Blue Chip Stamps* had

adopted the purchaser-seller requirement "because of 'policy considerations.' "

In *Musick, Peeler & Garrett v. Employers Insurance of Wausau,* the Court cited *Blue Chip Stamps* as "recognizing the authority of federal courts to define the contours of a private cause of action under Rule 10b-5," in the *absence* of "congressional enactment." 508 U.S. 286, 293 (1993) (quotation omitted). The Court noted that Congress had "made no attempt to define the precise contours of the private cause of action under § 10(b)" and, therefore, "had no occasion to address how to limit, compute, or allocate liability arising from it." *Id.* at 295.

Musick also observed that Congress had apparently chosen to continue to avoid "entangling" itself in the formulation of rules defining the contours of the private cause of action under § 10(b). *Id.* at 294. *Musick* interpreted Congress' enactment of legislation limiting the retroactive effect of the Court's decision as to the applicable statute of limitations for Rule 10b-5 actions, as an "acknowledgment of the 10b-5 [private] action, without any further expression of legislative intent to define it," and a decision to leave rules delineating private Rule 10b-5 actions up to the courts. *Id.* It concluded, "That task, it would appear, Congress has left to us." *Id. Musick,* as other decisions before it, continued in the *Blue Chip Stamps* tradition by fashioning an additional judge-made rule governing private actions under Section 10(b) and Rule 10b-5.

Central Bank v. First Interstate Bank, 511 U.S. 164, 172 (1994), reiterated the same understanding. The Court noted that its decisions with respect to Section 10(b) and Rule 10b-5 actions fell into two categories. With respect to the first – determining "the scope of conduct prohibited by § 10(b)—the Court stated that "the text of the statute controls our decision." *Id.* at 173. With respect to the second—"determining the elements of the 10b-5 private liability scheme"—*Central Bank* explained that the Court